United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-1643

In The

United States Court of Appeals

for the Second Circuit

MAX S. GUMER,

Appellant,

vs.

SHEARSON, HAMMILL & CO., INC.; WINSLOW, COHU & STETSON, INC.; FREDERICK S. NUSBAUM and THE NEW YORK STOCK EXCHANGE,

Appellees.

Appeal From The United States District Court For The Western District of New York

BRIEF FOR APPELLANT MAX S. GUMER

WISER SHAW FREEMAN VAN GRAAFEILAND HARTER & SECREST
Attorneys for Appellant
Office and Post Office Address
700 Midtown Tower
Rochester, New York 14604
Telephone: 232-6500

John F. Mahon, *of counsel*

Daily Record Corporation
Rochester, New York

TABLE OF CONTENTS

CITATIONS

Page

STATUTES

FEDERAL RULES AND REGULATIONS

MISCELLANEOUS

In The

United States Court of Appeals

for the Second Circuit

MAX S. GUMER,

Appellant,

vs.

SHEARSON, HAMMILL & CO., INC.; WINSLOW, COHU & STETSON, INC.; FREDERICK S. NUSBAUM and THE NEW YORK STOCK EXCHANGE,

Appellees.

Appeal From The United States District Court For The Western District of New York

---

BRIEF FOR APPELLANT MAX S. GUMER

Preliminary Statement

This is an appeal from an Order of April 1, 1974 of Honorable Harold P. Burke, United States District Judge for the Western District of New York which dismissed all of the causes of action of plaintiff's complaint purporting to allege liability of defendant Shearson to the plaintiff and which declined plaintiff's request for leave to amend the complaint. The decision of the Court below is not reported, but is set out in full in the appellant's appendix (p. A-35).

Before the Court below were plaintiff's complaint (p. A-1) and three affidavits attached to defendant Shearson's motion to dismiss (pp. A-24 through A-34) apparently submitted to show the existence of an arbitration clause in the margin agreement (p. A-28), the request for arbitration (p. A-30) and plaintiff's answer thereto (p. A-32). Plaintiff does not dispute the existence of the agreement nor that he received and sent letters. For the

convenience of this Court all of the papers before the Court below have been printed in appellant's appendix and, for clarity, all references to the allegations of the complaint are to the numbered paragraphs thereof.

Issues Presented For Review

1. Under the facts of this case was it a violation of Regulation T, specifically §6(d)(1) thereof, for defendant Shearson to have accepted, as transferee broker-lender, accounts and securities with the knowledge that there had been transactions effected in the said account for which improper cash and securities had been deposited?

2. Under the facts of this case was it a violation by defendant Shearson of §7 of the 1934 Act and of Regulation T, specifically §§6(d)(2) and 7(a) thereof, to have participated by its request and by the refinancing thereof, of a transfer of securities from one customer to another at another brokerage house under which the conditions and provisions of §6(d)(2) had not been met?

3. May an account and securities thereof be maintained by a transferee broker-lender pursuant to §7(b) of Regulation T when that transferee-lender has knowledge or should have knowledge that credit for the purchase of many of the securities in the said account had initially been extended in violation of Regulation T?

4. Do the facts of this case as alleged in the complaint state a violation of Rule 405 of the New York Stock Exchange?

5. Is a violation of Rule 431 of the New York Stock Exchange the basis for an implied private cause of action under the Securities Exchange Act of 1934 and do the facts of this case set forth a violation of that Rule upon which recovery may be had against defendant Shearson?

6. Do the facts of this case as alleged in the complaint set forth one or more affirmative acts and material omissions which constitute violations by defendant Shearson of Rule 10b-5?

7. Does the complaint allege scienter with respect to the alleged 10b-5 violations by defendant Shearson?

Statement of The Case

This is an action for damages against four defendants for violations of §§6, 7 and 10 of the Securities Act of 1934 and of New York Stock Exchange (NYSE) Rules 405 and 431, and of Federal Reserve Board Regulation T and Rule 10b-5. By a succession of sophisticated manoeuvres, securities violations and frauds, the various defendants in succession, and severally and jointly, manoeuvred plaintiff into a position whereby he lost his entire securities account which at the beginning, we now know, was worth a net of $1,461,437.60. Without the participation of all of the defendants in the scheme of violations and frauds plaintiff would not have lost his entire account and for proper recovery plaintiff must have available to him each of the defendants who participated in the scheme. One of those defendants has moved to dismiss the complaint and such motion has been granted by the Court below which, in its opinion, did not focus upon the allegations of the complaint, their import, or the laws and regulations applicable thereto.

Even though this appeal concerns the motion of only one of the defendants against the complaint, this Court must understand that that defendant, Shearson, was only one of the parties to a continuing scheme of fraud and violation. The complaint therefore must be read and understood as a whole, keeping in mind the realities of the brokerage industry. The factual allegations, from which the legal conclusions are drawn, are grouped chronologically into four sections. The legal con-

erspersed among the facts in eleven counts, each ns one or more causes of action. While the facts nt are chronologically stated, the arguments set rief will be subdivided by legal theory. Because volves a motion to dismiss the complaint, the uld be liberally construed and the allegations e.

Facts

me prior to July of 1969 plaintiff maintained a account at the Rochester office of defendant ntiff alleges that, in that month, defendants Nusbaum fraudulently induced him to sign a ranteeing the maintenance margin of two other P.R. & L.G. accounts) in which plaintiff had no which he had no knowledge (¶ 9 through 29). s that he was defrauded with respect to that hat the combined P.R. & L.G. accounts were at guarantee in actual deficit (negative value) and was not disclosed to him (¶ 12 *et seq*). Plaintiff ose facts give rise to causes of action against Nusbaum which he sets forth in the first three

set of facts (¶ 31 through 38) alleges that, e plaintiff, "all or substantially all of the securities e P.R. & L.G. accounts" had been originally subsequently carried by use of excessive credit or payment at all (¶ 32) and that Winslow and engaged in a consistent scheme to effect these hases (¶ 31). Because the P.R. & L.G. accounts , Winslow, after securing plaintiff's guarantee, egan selling securities from plaintiff's own ac- e the enormous debt of the other accounts and damaged thereby (¶ 38). In the fourth count

plaintiff alleges remedies against Winslow and N relating to Sections 6, 7 and 10 of the 1934 Act and R Regulation T and Rule 10b-5, respectively pro thereunder.

As a result of these violations, among others, d Winslow's net worth became impaired and Winslow wa out of business and into forced sales and transfers brokerage houses (¶ 40 and 41). In order to reduce mous debt Winslow was improperly forcing liquidation rities from plaintiff's own account (¶ 38) which plai powerless to stop. Faced with loss of his substantial acc the imminent financial collapse of defendant Winslo had possession of all of his securities, plaintiff atte transfer his account alone away from defendant Wi another brokerage house (he was solicited by an em Shearson), namely Shearson. However, defendant under the color of its fraudulent guarantee (¶ s19 declined to permit that transfer unless plaintiff also t him the P.R. and L.G. accounts or otherwise found som pay off the excessive debt of those accounts. Shearso other hand having knowledge of the credit violati background of the P.R. and L.G. accounts (¶ s 46, 47 declined to accept any securities in the name of P.R. a but told plaintiff it would accept the same securities counts if they could be transferred to plaintiff's name. for the purpose of transferring his own securities out of and into Shearson plaintiff was compelled to consol account with those of P.R. and L.G. (¶ 43). Ac plaintiff alleges that, while he was unaware of these pri violations and the consequences thereof (¶ 52), d Shearson, along with defendant New York Stock Excha fully aware of the fraudulent scheme which generated t purchases of many securities contained in plainti solidated account (¶ s 48 and 51). He alleges that not

Nusbaum
Rule 431,
mulgated

efendant
as forced
to other
its enor-
of secu-
ntiff was
ount, and
w which
mpted to
nslow to
ployee of
Winslow,
and 38)
ook with
ne way to
n, on the
ons and
and 50),
nd L.G.,
and ac-
So, solely
Winslow
idate his
cordingly
or credit
efendant
nge, was
he illegal
ff's con-
only did

defendant Shearson have knowledge of the illegal purchase credit existing in the said accounts (¶s 46, 47, 50 and 51) but that defendant Shearson knew that the consolidation was for the purpose of transferring the consolidated account to it (¶s 43 and 46) and that the accounts should have been liquidated rather than consolidated and transferred (¶ 47). He alleges that the consolidation itself was a sale (¶ 49) to him of the P.R. and L.G. securities which sale was illegal in and of itself because of the insufficient equity contained in his own account for such a purchase (¶ 51). (Subsequent to the drafting of the complaint, after making the complex numerical calculations which Shearson presumably had done, plaintiff confirmed the fact that his account had woefully insufficient "free capital" to support the consolidation-sale, thus demonstrating its illegality.)

Plaintiff in his fifth count, alleges various violations and remedies especially that the sale and consolidation was a violation of Regulation T by Winslow (¶ 42) and, in his sixth count, alleges that the said sale, consolidation and transfer were violations of Regulation T and of Section 10 of the 1934 Act and Rule 10b-5 by defendant Shearson (¶ 52 and 53).

For his last set of facts, plaintiff alleges that at the time his now consolidated account was transferred to defendant Shearson it contained large blocks of improperly evaluated securities which had derived from P.R. & L.G. (¶ 48), and it was below both the 30% maintenance margin required by Shearson (house margin) and the minimum maintenance of 25% required by Rule 431 of the New York Stock Exchange (the "Exchange Margin") despite Shearson's representations of compliance (¶ 55 and 56). Thereafter, Shearson informed plaintiff it was properly computing the aforesaid house margin and Exchange Margin on a daily basis to assure compliance (¶ 56 and 57) and for a period plaintiff was called almost daily and advised of his margin status, as well as the amount, if any, required from time to time to be raised by liquidation (¶ 58).

Plaintiff was allowed only to select the securities to be sold to meet any such calls (¶ 58). Plaintiff relied on these calculations and to his knowledge such calculations were being correctly made. But, starting in February, defendant Shearson withheld from plaintiff any information about his account (¶ 61) while continuing to represent that it was in compliance with the maintenance margin requirements (¶ 57). In fact, he did not even receive statements for February, March or April, 1970 despite his objections and requests (¶ 61). Finally, on April 27 he was advised that his maintenance position had fallen to 4%, far below the 25% minimum, and over the next few weeks Shearson liquidated his entire account without consultation of any kind (¶ 61). In his eighth count plaintiff alleges that such acts violated Section 6 and 7 of the 1934 Act and Rule 431 of the Exchange and Regulation T of the Federal Reserve Board promulgated thereunder (¶ 67). In his tenth count plaintiff alleges that such violations, especially when they were coupled with defendant Shearson's representations to the contrary were also a violation of Section 10 of the Act and Rule 10b-5 thereunder (¶ s 73, 74 and 75). Plaintiff also alleges negligence (seventh count), breach of fiduciary duty (ninth count) and breach of contract (eleventh count).

ARGUMENT

POINT I

Violations of Regulation T

By virtue of §7 of the Securities Exchange Act of 1934 (15 U.S.C. 78g), Congress enacted legislation to prevent "the excessive use of credit for the purchase and carrying of securities". In §7(c) Congress proscribed broker/dealers such as Shearson from *directly* or *indirectly* (1) extending, (2) maintaining, or (3) arranging for any credit to a brokerage customer on any security in contravention of rules and regulations prescribed by the Federal Reserve Board:

> It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer — (1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe . . . (15 U.S.C. 78g(c))

Because it recognized the impossibility of adequately controlling such a complex and specialized industry by legislation alone, Congress mandated that the Board should prescribe such rules and regulations, even suggesting certain areas of operation peculiar to the brokerage industry which it would be appropriate to regulate. Section 7(a) of the Act provides:

> For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, . . . prescribe rules and regulations with respect to the amount of credit that may be *initially extended* and *subsequently maintained* on any security . . . Such rules and regulations may make appropriate provision with respect to . . . the *transfer of accounts from one lender* to another . . . (emphasis added) (15 U.S.C. 78g(a))

Pursuant to that congressional mandate the Board has promulgated several regulations supplementing the statute. There is no doubt that a private cause of action may be maintained by an individual investor against his creditor/lender for a violation of the statute and the regulations. "Every court that has considered the question has determined that . . . there is a private right of action for violations of §7, and no cases to the contrary are cited by the defendants." (*Livingstone* v. *Weis Voisin, Cannon, Inc.*, 294 F. Supp. 676 (D.C.N.J. 1968)). Although neither Congress nor the Federal Reserve Board specifically authorized private actions, it has long and universally been recognized by the courts that the best and perhaps only way to force the brokerage industry to police itself

and "follow the regs" is to encourage civil liability when the rules are not followed. *Smith* v. *Bear Stearns & Co.*, 237 F. 2d 79 (2d Cir. 1956); *Zatz* v. *Hertz*, 262 F. Supp. 928 (S.D.N.Y. 1966); *Warshow* v. *H. Hentz & Co.*, 199 F. Supp. 581 (S.D.N.Y. 1961); *Remar* v. *Clayton Securities Corp.*, 81 F. Supp. 1014 (D.C. Mass. 1949); and other citations, infra.

Plaintiff claims damages resulting from defendant Shearson's violation of the statute and of one of the regulations promulgated thereunder — Regulation T (12 C.F.R. 220).

Congress clearly intended that a comprehensive scheme be developed which would control the use of credit throughout all phases of the securities industry both for the protection of the economy and general public from excessive speculation, and for the protection of the individual "margin purchaser by making it impossible for him to buy securities on too thin a margin." (S. Rep. No. 1455, 73d Cong., 2d Sess. 11 (1934)). The concept of Regulation T is simple: A broker cannot himself extend, nor participate in the extension by anyone else, of proscribed credit, and if he does, he must *immediately* take whatever steps are necessary to eliminate that credit — i.e., once improperly extended it may *not* be continued or maintained — or he will be absolutely liable to his debtor — customer for whatever damages result because of that credit.

The plan begins with Section 3 of the Regulation which sets forth the standards to be used in initially extending credit, the computation thereof, and the duty of the broker if the customer's payments are not sufficient to meet those standards. §3(b) provides that:

> . . . a creditor shall not effect for or with any customer . . . any transaction which, in combination with other transactions effected in such account on the same day, creates an excess of the adjusted debit balance of such account over the maximum loan value of the securities in such account, or increases any such excess, unless in

> connection therewith the creditor obtains as promptly as possible and in any event before the expiration of 5 full business days following the date of such transaction, the deposit into such account of cash or securities in such amount (which will satisfy the requirements of this section) . . . (12 C.F.R. 220.3(b))

Section 3(e) then mandates that the creditor-broker must liquidate any securities subject to the Regulation for which proper payment has not been made:

> *Liquidation in lieu of deposit.* In any case in which the deposit required by paragraph (b) of this section, or any portion thereof, is not obtained by the creditor within the 5-day period specified therein . . . securities shall be sold . . . prior to the expiration of such 5-day period in such amount (as will satisfy the requirement of §3(b)) . . . (12 C.F.R. 220.3(e))

"The duty of the broker is made completely clear by the Regulation — if the investor has not made sufficient deposit to meet the margin requirements within the 5-day period, the broker is required to liquidate in order to cover the position." (*Avery* v. *Merrill Lynch*, 328 F. Supp. 677, 680 (D.C. Dist. of Col. 1971)). That mandate by §3(e) starts within five days after the "transaction" and, as this Court recognized in *Pearlstein* v. *Scudder and German*, 429 F. 2d 1136 (2d Cir. 1970), cert. den., 401 U.S. 1013 (1971), it follows the securities and the financing brokers thereof wherever they may be — the obligation *never* ends.

Pearlstein illustrates that a broker may not participate in arranging for credit which is illegal, even if he, himself, does not extend it (id., at p. 1139, 40); he must even "take reasonable steps to prevent (at no risk to the broker) the execution of a transaction which has become illegal subsequent to the arrangement of a loan to finance it." (id., at p. 1140) The broker has the sole and continuing duty to eliminate the credit once it is improperly extended:

> . . . margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit. This fact appears to indicate that Congress has placed the responsibility for observing margins on the broker . . . (id., at p. 1141)*

The broker must even initiate legal action to eliminate an improper credit, if necessary:

> . . .defendant should have used its best efforts to secure the return of the bonds which it had improperly delivered to the banks, by replevin if necessary, and to sell them. Defendant's failure to take such action resulted in a *continuation* of the credit in violation of Regulation T . . . (emphasis added) (id., at p. 1142)

No agreement between customer and broker can relieve a broker of this duty. Neither a stipulation of settlement after legal action has been commenced between the parties nor even a judgment therein can cure the illegal credit if the effect thereof is to continue it. Any act by the broker or failure of an act by the broker which would serve to refinance or further extend a credit initially extended in violation of the Regulation is a further violation (id., pp. 1142-4). The failure of the broker to liquidate the credit is a *per se* violation rendering the broker absolutely liable for damages resulting to a customer from the violation (see *Landry* v. *Hemphill, Noyes & Co.*, 473 F. 2d 365 (1st Cir. 1973), cert. den. 414 U.S. 1002 (1973), reh. den. —— U.S. ——, and *Spoon* v. *Walston*, 345 F. Supp. 518 (E.D. Mich. 1972), *aff'd* 478 F.2d 246 (6th Cir, 1973).)

---

*At the time of the violations alleged in this case, there was no corresponding responsibility on the part of the customer. Subsequently, and effective November 1, 1971, the Federal Reserve Board promulgated Regulation X (12 C.F.R. 224) which provides in substance that a borrower shall not obtain credit from a broker-dealer unless that credit conforms to the provisions of Regulation T (12 C.F.R. 220). Section 2(a) (2) of Regulation X appears to make the prohibitory rules apply to a customer and broker alike. However, such is not the law applicable to this case.

If the principle and mandate of *Pearlstein* are applied to the facts of this case it is clear that Shearson had a responsibility not to involve itself in the illegal credit of the P.R. and L.G. securities but once having involved itself had the immediate duty to liquidate that credit under the mandate of §3(e). Although *Pearlstein* did not consider the precise facts here before the Court, the principles and mandates of that case when read together with those sections of Regulation T most applicable to our facts make clear the responsibility of Shearson at the time it involved itself in the illegal credit and now make clear the liability of Shearson to the plaintiff.

These sections are those relating to transfer of account — §6(d), arranging for loans by others — §7(a) and maintenance of credit — §7(b), which we set forth here for convenience of reference:

> §6(d) (1) In the event of the transfer of a general account, special bond account, or special convertible security account from one creditor to another, such account may be treated for the purposes of this part as if it had been maintained by the transferee from the date of its origin: *Provided*, That the transferee accepts in good faith a signed statement of the transferor that no cash or securities need be deposited in such account in connection with any transaction that has been effected in such account or, in case he finds that it is not practicable to obtain such a statement from the transferor, accepts in good faith such a signed statement from the customer.
>
> (2) In the event of the transfer of a general account, special bond account, or special convertible security account, from one customer to another, or to others, as a *bona fide* incident to a transaction that is not undertaken for the purpose of avoiding the requirements of this part, each such transferee account may be treated by the creditor for the purposes of this part as if it had been maintained for the transferee from the date of its origin: *Provided*, That the creditor accepts in good faith and keeps with such transferee account a signed

statement of the tranferor describing the circumstances giving rise to the transfer. (12 C.F.R. 220.6(d))

§7(a) A creditor may arrange for the extension or maintenance of credit to or for any customer of such creditor by any person upon the same terms and conditions as those upon which the creditor, under the provisions of this part, may himself extend or maintain such credit to such customer, but only upon such terms and conditions, except that this limitation shall not apply with respect to the arranging by a creditor for a bank subject to Part 221 of this Chapter (Regulation U) to extend or maintain credit on margin securities or exempted securities. (12 C.F.R. 220.7(a))

§7(b) Except as otherwise specifically forbidden by this part, any credit initially extended without violation of this part may be maintained regardless of (1) reductions in the customer's equity resulting from changes in market prices, (2) the fact that any security in an account ceases to be margin or exempted, and (3) any change in the maximum loan values or margin requirements prescribed by the Board under this part. In maintaining any such credit, the creditor may accept or retain for his own protection additional collateral of any description, including non-margin securities. (12 C.F.R. 220.7(b))

This Court and the brokerage community are well aware of the difference between purchase money margin requirements and maintenance margin requirements. The former are governed by Regulation T; the latter (discussed in Point III, infra) are governed by New York Stock Exchange Rule. While as noted above in §7(a) of the 1934 Act, (supra page 8), the Board is authorized to provide rules for maintenance margin, it has, recognizing both the concurrent jurisdiction of the Securities and Exchange Commission and the national exchanges under §19(b) of the 1934 Act, determined to allow such provisions to be determined in that forum. Therefore, the Board has promulgated under §7(b) of Regulation T a general rule that says any credit can be maintained for the purposes of

Regulation T provided that at the time of its initial extension such credit did not violate any other prohibition of Regulation T: "Except as otherwise specifically forbidden by this part, any *credit initially extended without violation* of this part *may be maintained* . . . (emphasis added)." (§7 (b)). It is clear that this permissive maintenance of credit is specifically contingent upon the initial credit having been extended without violation of §3 of the regulation. In other words, if the standard of §3(b) and the mandate of §3(e) have not been followed, a broker cannot "cure" a violative initial purchase credit by simply "maintaining" it. That is the rule of *Pearlstein* and that is the rule of Regulation T as specifically set out in §7(b).

That, in fact, is the consistent rule of Regulation T, by its own terms. Winslow, having ignored the standard and mandate of §3 of the Regulation, attempted to cure the situation by duping the plaintiff into signing a guarantee for maintenance purposes. But that guarantee had no curative effect whatsoever on the illegal purchase money margin which Winslow was improperly maintaining for §6(c) of the Regulation provides: "No guarantee of a customer's account shall be given any effect for the purposes of this part." (12 C.F.R. 220.6(c))

Just as the initial credit violation could not be cleansed under the color of "maintaining" it through changing market conditions under §7(b) nor by securing a guarantee for it under §6(c), it could not be cleansed by simply transferring the credit from one broker to another — from Winslow to Shearson — as was attempted here. If there were any doubt that a transferee-broker could free an illegal credit of its taint merely by accepting and refinancing the illegal credit and thereby circumventing the condition precedent expressed in §7(b), that doubt is removed by §6(d)(1) which sets forth in the words of §3(b) that which is required of the transferee-broker when he accepts a general account if he wishes to be free of the liquidation mandate of

§3(e) and enjoy the permissive maintenance granted by §7(b). In accepting the transferred account, the transferee-broker must accept "... in good faith a signed statement of the transferor that no cash or securities need by deposited in such account in connection with any transaction that has been effected in such account ...". Only then can the transferee-broker escape the continuing mandate of liquidation expressed in the Regulation and in *Pearlstein;* only then, in the words of §6(d)(1) may such account "be treated for the purposes of this part as if it had been maintained by the transferee from the date of its origin ..." and thus become an account allowed the permissive maintenance of §7(b). Obviously Shearson did not, and with its knowledge could not, have received plaintiff's consolidated account pursuant to the terms of §6(d)(1).

This is true not only because Shearson accepted plaintiff's consolidated account knowing that it contained many securities with initial credit violations derived from the P.R. and L.G. accounts, but also because it knew that it was refinancing the consolidation itself — the purchase by plaintiff of the P.R. and L.G. securities. That consolidation was a sale, even requiring a special waiver of the NYSE commission requirement. Since plaintiff's own account did not have sufficient equity in it to make those purchases (as then required by §8(a)(1)) of the Regulation) the consolidation was, in itself, an illegal sale to the plaintiff requiring immediate "deposits" or "sales" mandated by §3(e) notwithstanding the initial credit violations still existing in the accounts. Under the circumstances and the rule of §6d(1) that duty was as much Shearson's as it was Winslow's.

The importance of §6(d)(1) in the regulatory scheme should not be minimized for it is a section which directly implements the Congressional mandate under the 1934 Act. It regulates "... transfer of accounts from one lender to another ..." specifically suggested by Congress in §7(a) of the Act as an appropriate area to regulate (see p. 8 supra). Shearson's

flagrant violation of this section of Regulation T not only did nothing to relieve it of the mandate of appropriate liquidation, but by permitting and being a party to the illegal transfer, Shearson was also guilty of a per se violation of the Regulation.

Our discussion of §6(d) so far has focused only on the first subsection. However, Shearson violated §6(d)(2) as well. As above noted, Winslow was content to be rid of plaintiff, but only if he would take the P.R. & L.G. accounts with him. On the other hand, Shearson actively sought plaintiff's own valuable account but wanted no securities in the names of P.R. & L.G. Shearson, knowing that it could not obtain plaintiff as a customer without satisfying Winslow's requirement, agreed to accept a consolidated account containing all the securities and to refinance the combined debt of the three former accounts. In so doing it requested Winslow's act of consolidation as structured. Without that request and without Shearson's agreement to accept the combined accounts and to provide the refinancing for them there would have been no customer-to-customer transfer (consolidation) at Winslow. By thus participating in that consolidation Shearson violated subsection (2) as an arranger of the credit in violation of the 1934 Act as implemented by §7(a) of the Regulation.

Of course, there is little doubt that the customer-to-customer transfer at Winslow was in violation of §6(d)(2). The securities could not possibly have been transferred at Winslow as "a *bona fide* incident to a transaction that is not undertaken for the purpose of avoiding the requirements of this part . . ." as required by that subsection. They were transferred (consolidated) precisely to avoid the requirement of liquidating the P.R. and L.G. accounts alone (there being insufficient equity therein). As with a violation of subsection (d)(1) this customer-to-customer transfer was (1) a violation in itself, and (2) did nothing to free Winslow from its continuing duty to liquidate.

By participating in that violation, by its request for the consolidation and by its agreement to refinance it, Shearson was equally guilty of a violation of that subsection. Section 7 (c) of the 1934 Act specifically makes it "... unlawful for ... any broker or dealer, *directly* or *indirectly*, to extend or maintain or *arrange* for the extension or maintenance of credit..." (emphasis added) in contravention of the Regulations (see p. 8 *supra*). Section 7 (a) of Regulation T permits a broker to "... arrange for the extension or maintenance of credit ... upon the same terms and conditions as those which the creditor ... may himself extend or maintain ... *but only upon such terms and conditions* ...". (emphasis added) (see p. 13 supra)

Applying the statement of law outlined in *Pearlstein* to the facts of this case and to the above-cited sections of Regulation T, it is clear that plaintiff has stated causes of action against Shearson for its violations of §7 of the 1934 Act and of Regulation T in two counts. The first cause of action, relating (1) to the consolidation and (2) to the acceptance of plaintiff's account by Shearson is asserted in the sixth count. That cause of action must be sustained because of Shearson's participation in the consolidation and because of its acceptance of the account despite its knowledge of the illegal credit therein. The second cause of action, relating to the maintenance of the account once transferred, is asserted in the eighth count of the complaint. That count must be sustained because of Shearson's continued maintenance of the illegal purchase credit over an extended period of time.

POINT II

Violation of Rule 405 of the New York Stock Exchange

The New York Stock Exchange (NYSE) has promulgated pursuant to the requirements of Sections 6 and 19 of the 1934 Act a body of Rules which are subject to the approval of the Securities and Exchange Commission. While many of these rules are designed to govern relationships between brokers inter se and between brokers and the New York Stock Exchange, a substantial number of such rules regulate the conduct of member firms in accepting, handling, maintaining and financing customer accounts. As will further be discussed infra, under *Point III — Violation of Rule 431 of the New York Stock Exchange*, this distinction in purpose has resolved itself to a question of whether the rule was designed for the protection of customers and the public and/or as a "housekeeping rule."

Violations of NYSE rules designed for the protection of customers and the public are actionable for civil damages in private actions both on general principles of tort and because such actions enforce and further the regulatory scheme of the Securities Acts (Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 Columbia L.R. 12, 28-30 (1966); *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir., 1966), cert den. 358 U.S. 817, 17 L.Ed 2d 56 (1966) and Point III infra). The *Colonial* case will be discussed in detail hereinafter in connection with Rule 431. We omit discussion of this case at this time because the subject of this Point II — violation of Rule 405, the so-called "Rule of Due Diligence", has already been held to meet the *Colonial* criteria and to form the basis of private cause of action for damages in the leading case of *Buttrey v. Merrill Lynch Pierce Fenner & Smith, Inc.* 410 F. 2d 135 (7th Cir. 1969), cert. den, 396 U.S. 838 (1969).

Rule 405 states:

Every member organization is required through a general partner or an officer who is a holder of voting stock to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

(2) Supervise diligently all accounts handled by registered representatives of the organization.

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization. (CCH New York Stock Exchange Guide, ¶ 2405, as effective during the period in question).

In *Buttrey* the Court sustained the district court's decision to deny defendant's motion for summary judgment holding directly that a

> Violation of Rule 405 of the New York Stock Exchange May be Actionable (id at p. 141).

In explanation the Court further stated:

> Here one of the functions of Rule 405 is to protect the public, so that permitting a private action for its

> violation is entirely consistent with the purposes of the statute (id at p. 142).
>
> Although a mere error of judgment by defendant might not support a federal cause of action, the facts alleged here are *tantamount* to fraud . . . . thus giving rise to private civil damage action. See *Hecht* v. *Harris Upham & Co.* 283 F. Supp. 417, 430, 431 (N.D. Cal. 1968) (id at p. 143) (emphasis added).

Under Count 6 plaintiff has alleged that Shearson (a) knew or should have known of the fraudulent genesis of the L.G. and P.R. accounts, constituent parts of the ultimate consolidated account, (b) knew plaintiff was consolidating under duress and in further violation of Regulation T. and (c) knew or should have known that the transfer of the consolidated account both continued the prior violations of Regulation T as aforesaid and was unacceptable under the provisions of Rule 431 (see Point III infra) since as alleged Shearson had the opportunity prior to accepting the plaintiff's account to examine separately the account statements for each of the three accounts and had been informed of the details of those accounts by Winslow and the NYSE.

Assuming all of these facts are true one of the two conclusions *must* necessarily follow the mandated application of Rule 405:

(A) Shearson knew of the sundry violations of Regulation T and the deficiency of the consolidated account under Rule 431 and nevertheless allowed such account to be opened and maintained in crass violation of its obligation to Section (2) of Rule 405 to:

> (2) *Supervise diligently* all accounts handled by registered representatives of the organization (emphasis added).

or

(B) Shearson ignored the facts presented, and/or did not actually review the account statements handed to it, and/or did

not question Winslow in accord with the requirement of Section 6(d)(1) of Regulation T as to the reasons for the transfer; and/or did not make the computations required by NYSE Rule 431 *in any of which events* it opened and maintained the account in violation of its obligation under Section (1) of Rule 405 to:

> (1) *Use due diligence to learn the essential facts relative to every customer*, every order, *every* cash or *margin account accepted or carried* by such organization and every person holding power of attorney over any account accepted or carried by such organization (emphasis added).

Under either conclusion above it is evident that the violations of Rule 405 consist of "... an almost callous disregard for the requirements of Rule 405 and its purpose to protect the public" (*Buttrey* at p. 141). Even under the best light for Shearson the facts alleged constitute wilful or reckless misconduct, gross negligence "...*tantamount* to fraud" in executing the required inquiry into the establishment of the account (id at 143 citing *Hecht* v. *Harris Upham* at 430).

Accordingly, plaintiff has alleged facts actionable under Rule 405 in complete accordance with the requirements of the *Buttrey* case, and thereby stated a cause of action under count 6.

POINT III

Violation of Rule 431 of the New York Stock Exchange

NYSE Rule 431(b) requires that every margin account carried by a member firm at all times meet certain equity requirements in accordance with a specific formula provided. By way of general summary Rule 431 requires that on any day each such account shall have an equity value equal to at least 25% of the account's actual market value at the close of the preceding day. Substantial adjustments are required for (a) penny stocks;

(b) volatile stocks or those with thin markets and (c) short positions.

Individual brokerage houses frequently choose to supplement Rule 431 by requiring additional equity margin above the 25% NYSE requirement. This additional margin is known in the trade as "house margin" and varies from broker to broker. The purpose of the house margin is generally to provide a cushion against violation of Rule 431 and usually amounts to 5% to 10% additional margin.

A violation of NYSE Rule 431 has not yet been determined to be actionable by any federal court. The principal case on the general question of the existence of a private right of action under the Securities Laws stemming from a violation of rules and provisions arguably incorporated into the Securities Exchange Act of 1934 is *Colonial Realty Corp. v. Bache & Co.* (supra p. 18).

In the *Colonial* case plaintiff alleged that the broker, Bache & Co., orally agreed not to require margin in excess of the requirements of the New York Stock Exchange; i.e., Bache agreed not to enforce its house margin against his account. Thereafter, Bache sold shares in the account to meet margin requirements and plaintiff sued to recover losses arising out of sales used to meet calls exceeding the stock exchange's minimum. The plaintiff in *Colonial* claimed the breach of the oral understanding constituted a failure by Bache to:

> . . . conduct its dealings in a manner 'consistent with just and equitable principles of trade' within the meaning of §§6(b) and 15A(b)(7) of the Securities Exchange Act of 1934, of Article XIV of the Constitution of the New York Stock Exchange (NYSE) and of Article I, §2(a) of the By-Laws and Article III, §1 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (NASD). (id at 180).

In short plaintiff in *Colonial* alleged Bache had acted unprofessionally in requiring a house margin after orally agreeing not to. This Court in deciding the issue stated:

> What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing base urged by the two parties; rather the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law. The rules here at issue, however, are near the opposite pole. Although they do impose a duty upon members not to engage in conduct inconsistent with fair and equitable principles of trade, which the exchange or association can enforce through disciplinary proceedings, they are something of a catch-all which, in addition to satisfying the letter of the statute, preserves power to discipline members for a wide variety of misconduct, including merely unethical behavior which Congress could well not have intended to give rise to a legal claim. We find little reason to believe that by requiring exchanges and dealers' associations to include such provisions in their rules Congress meant to impose a new legal standard on members different from that long recognized by state law. See Note, *Implying Civil Remedies From Federal Regulatory Statutes*, 77 Harv.L.Rev. 285, 292 (1963). (id at 182)

Thus, *Colonial* establishes general criteria under which a violation of a particular stock exchange rule may be determined actionable (id at 182 — quoted above), while deciding directly only that Section 6(b) of the 1934 Act, the cited sections of NYSE constitution and the By-Laws and Article III §1 of the Rules of Fair Practice of the NASD do not meet these criteria

since they establish an ethical rather than legal standard. At no time did the Court in *Colonial* consider NYSE Rule 431, the subject of this Point III in the instant case, (See Wolfson and Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 Cal. L.R. 1120 at 1140 and 1141, particularly footnote 99, 1970).

Therefore it is necessary to apply the Colonial criteria or analysis to NYSE Rule 431. Under that analysis the principal question is what is the nature and the position of NYSE Rule 431 within the regulatory scheme of the securities laws taken as a whole? Section 19(b) of the 1934 Act empowers the Securities and Exchange Commission to intervene in the working of any national securities exchange to force it to establish rules in certain specified areas if the exchange fails to act. Section 19(b) states in pertinent part:

> The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect to such matters as . . . (12) *minimum deposits on margin accounts;* and (13) similar matters. (15 USC 78s (b) (1964)) (emphasis added)

There can be no question that NYSE Rule 431 is responsive to the demands of the Congress in Section 19(b) of the 1934 Act for establishing rules ". . . necessary or appropriate for the protection of investors . . ." with respect to ". . . deposits on margin accounts." In discussing the grant of jurisdiction over

maintenance margin given the Commission under Section 19(b), Wolfson and Russo, both members of the staff of the Securities and Exchange Commission, have noted:

> The importance of proper maintenance and handling of customer's margin accounts is obvious and violation of specific exchange rules dealing with this subject should be a source of civil liability. Generally, effective exchange rules in this area will lessen the risk of excess speculation with thinly-margined accounts (*Wolfson and Russo*, op cit. at 1140 and 1141).

The exchanges have all adopted Rules covering the points specified in Section 19(b), including maintenance margin requirements. It is apparent then from Section 19(b) that NYSE Rule 431 is not a mere self-policing or housekeeping measure for the broker's protection which may be abandoned at any time at the whim of the promulgating exchange and its members; rather it is designed primarily to protect the public and cannot be abandoned or modified without the prior approval of the Securities and Exchange Commission. In fact this overview by the Securities and Exchange Commission of rules promulgated by an exchange under Section 19(b), and by implication both the importance of such rules to the public and their place in the scheme of securities regulation, have recently been held by this Court to provide anti-trust immunity for the operation of such rules. *Gordon v. New York Stock Exchange, Inc.*, F.2d (2d Cir. 1974). Certainly such protection must imply a correspondingly heavy responsibility to abide by such rules and further that such responsibility ought to be enforced by private causes of action for violations. See *Chris Craft Industries Inc. v. Piper Aircraft*, 480 F.2d 341, 356 (2d Cir. 1973) cert. den. 414 U.S. 910 (1973). NYSE Rule 431 is an obvious example which fits the Colonial court's statement that:

> . . . A particular stock exchange rule could thus play an integral part in SEC regulation notwithstanding the

> Commission's decision to a back-seat role in its promulgation and enforcement, . . . (*Colonial* at 182).

The *Colonial* analysis states that the implication for liability ". . . would be strongest when the rule imposes a duty unknown under common law" (id at 182). NYSE Rule 431 imposes a requirement of minimum collateral (subject to mathematical computation) for every loan while at common law this is purely a matter for mutual agreement between borrower and lender. Therefore under *Colonial* the case for implication of liability under Rule 431 is quite strong.

Colonial does not require as part of its basic analysis for establishing liability that the violation involve more than negligence but the Court in *Buttrey* might be deemed to imply such a requirement by its gratuitous handling of the question of "scienter" (*Buttrey* at 143, quoted above at P. 21).

Assuming arguendo the need for scienter or knowing misconduct (the antithesis of which is frequently described as mere negligence or error of judgment), the facts in this case show that Shearson acted in its violations of Rule 431 knowingly or with gross negligence and a willfull or reckless disregard for the truth:

It is not just mere negligence or an error of judgment, to open, in the face of the available information, an account which was instantly in violation of the requirements of NYSE Rule 431.

It is not just mere negligence or an error of judgment to have failed for the purpose of Rule 431 to conservatively value or ascribe no value to many securities in that account which securities defendant Shearson itself has described as ". . . thinly traded, speculative stocks whose prices were subject to wide variation in price." (See paragraph 5 of the affidavit of Philip J. Hoblin in support of Motion to Dismiss) — an admission by defendant and a characterization which is a practical paraphrase of Rule 431(d)(1) which states:

> (d)(1) Determination of Value of Margin Purposes. — Active securities dealt in on a recognized exchange shall, for margin purposes, be valued at current market prices. Other securities *shall be* valued conservatively in the light of current market prices and the amount which might be realized upon liquidation. *Substantial additional margin must be required in all cases where the securities carried are subject to unusually rapid or violent changes in value, or do not have an active market on a recognized exchange, or where the amount carried is such that it cannot be liquidated promptly.* (emphasis added) (CCH N.Y. Stock Exchange Guide at ¶ 2431).

It is not just mere negligence or an error of judgment for defendant Shearson to have taken two months or more to have discovered that plaintiff's account was well under the maintenance required by Rule 431 — i.e. 4% instead of the required 25%. It is particularly unbelievable that this was an excusable mistake or mere computational error when one considers that immediately prior to this devastatingly gross misconduct Shearson knew plaintiff's account was on the 25% edge as evidenced by its requirement of occasional margin sales immediately prior thereto, and that plaintiff requested information in this point to which no response was received.

While plaintiff considers that anyone of the above facts to be beyond the pale of any reasonable excuse, it is clear that these facts taken as a whole fall clearly within the above-quoted statement of *Buttrey*, supra p. 21, (which like this plaintiff assumed the need to show scienter for sake of argument [see *Wolfson and Russo* at 1131 especially notes 45 and 46]) ". . . the facts here are tantamount to fraud."

Accordingly since NYSE Rule 431 has a firm position within the Commission's regulatory scheme and since it imposes an explicit duty unknown to common law and since in addition plaintiff has alleged facts which demonstrate a wilful or reckless violation of the Rule there can be no question that plaintiff states a cause of action for violation of NYSE Rule 431 and the decision below must be reversed.

POINT IV

Violations of Rule 10b-5

Plaintiff has alleged in Counts 6 and 10 of his complaint that defendant Shearson has alone and in combination with other defendants violated Section 10 of the 1934 Act and Rule 10b-5 promulgated thereunder. Rule 10b-5 provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange,
>
> (1) to employ any device, scheme or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

There is no doubt that violation of Rule 10b-5 gives rise to civil damages recoverable in a private course of action. In *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 543 (2d Cir. 1967) this Court stated ". . . it is now common ground that an injured investor does have a private cause of action under Rule 10b-5".

In order to invoke Rule 10b-5 plaintiff must allege "a person" who "directly or indirectly" "in connection with a purchase and sale of any security" engaged in any of the types of activity prohibited thereunder.

That defendant Shearson is a "person" within Rule 10b-5 is beyond doubt (see §3(a)(9) (15 U.S.C. 78c (a)(9)) and §20 (15 U.S.C. 78t) of the 1934 Act.)

The "in connection with a purchase and sale of any security" requirement has recently been defined by the United States Supreme Court to be satisfied if the plaintiff ". . . suffered an injury as a result of deceptive practices *touching* its [purchases] sales of securities as an investor". (Emphasis and bracketed material added.) *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 US 6 (1971). Clearly the facts alleged "touch" upon the purchase and sale of securities since the contents of the subject accounts were common stocks — securities under Section 3(a)(10) of the 1934 Act (15 U.S.C. 78c(a)(10). Further the establishment of a margin account, i.e., an interest in stock and issuance of notes, is a "security" (*Tcherepnin v. Knight*, 389 U.S. 332, 335-336 (1967).

The case of *Shemtob v. Shearson, Hammill and Co.*, 448 F.2d 442 (2d Cir. 1971), on which the District Court bases part of its holding in the instant case and which will be discussed infra, recognizes in a margin account situation that:

> The application of §10(b) and its subsidiary rule in situations not involving the classic buyer-seller relationship is not unprecedented, see *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 858 (2d Cir. 1968); *A.T. Brod Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417 (N.D. Cal. 1968); *Lorenz v. Watson*, 258 F. Supp. 724, 732 (E.D.Pa. 1966), and we have jurisdiction under that section if the allegations of the complaint indicate that it has been properly invoked (id at 444).

It remains therefore only for plaintiff to demonstrate an allegation of facts under one or more of the three subsections of Rule 10b-5, set forth, supra, p. 28.

Under Count 6 the Court below has held that the allegation of the complaint that Shearson violated Rule 10b-5 by accepting the transfer of plaintiff's account from defendant Winslow is not sufficient to state a cause of action thereunder and further that a scheme or cause of conduct under 10b-5 by Shearson has not

been alleged. This holding ignores plaintiff's allegations of Shearson's knowledge of Winslow's action in forcing that consolidation; Shearson's knowledge of the earlier violation Regulation T in the L.G. and P.R. accounts; Shearson's knowledge that its refinancing of the accounts by the transfer and acceptance thereof was the essential ingredient which would make the scheme work.

Under Count 6 plaintiff has used the terms "consolidation", "transfer" and "acceptance". The context of these terms and allegations is "margin accounts" and these terms have a clear meaning in that context which defendant, a broker in the business of margin loans, cannot be heard to claim it does not understand so as to not have proper notice of plaintiff's claim. Thus "consolidation" incorporates and summarizes the entire economic process whereby an individual investor purchases the securities of another investor with a refinancing of the related debt and the subjection of his stocks to a security interest to secure that debt. Similarly "transfer" and "acceptance" incorporate an economic process whereby the transferor broker cancels credit, is repaid debt by the investor and surrenders all rights to the investor's stock as collateral as well as physical possession of that collateral while the accepting broker refinances or issues new credit, the investor issues new notes and grants security interest in the stocks, and the new broker takes physical possession of that collateral. As noted above, these processes themselves of "transfer" and "acceptance" constitute purchases and sales of securities consisting of notes, interest in securities, etc.

These processes of consolidation and transfer and acceptance were all essential ingredients of the continuing scheme whereby this plaintiff lost his entire and substantial account equity. Shearson's acts formed an essential link in that scheme.

Under Paragraph 43 of the complaint plaintiff alleges that the agreement requiring "consolidation" was void since it

formed part of a scheme to transfer improper accounts from Winslow to Shearson. Under Count 6, Paragraph 45 realleges Paragraph 43, and Paragraphs 46, 47, 50 and 53 allege Shearson's "acceptance" of the consolidated account with full and complete knowledge of all of the prior Regulation T violations and the Winslow scheme to force consolidation *and* transfer. In short plaintiff has alleged *a single scheme to consolidate and transfer*, not separate schemes, in an attempt to cover up these earlier violations and use plaintiff's equity to meet the deficits. Clearly the alleged knowing "acceptance" by Shearson forms an essential link in this scheme since the transfer could not be accomplished without such acceptance, and this is true whether one views Shearson as primary wrongdoer, or as an aider and abettor who rendered substantial assistance to the primary wrongdoer. *Brennan v. Midwestern United Life Insurance Co.*, 259 F.Supp. 673, 680-681 (N.D. Ind. 1966).

These facts are restated in summary under Paragraphs 51 and 52 together with further allegations threrein that Shearson knew these facts and the ultimate consequences thereof, that plaintiff did not and that Shearson *failed to disclose and concealed* these facts. Shearson's basic obligation to disclose is postulated by its fiduciary capacity. Clearly these were material omissions under Rule 10b-5 in that such facts and conclusions would affect the judgment of the ordinary investor in determining whether or not to "consolidate and transfer" his account to Shearson, i.e., buy the L.G. and P.R. accounts on credit to be supplied eventually by Shearson.

> . . .All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . this obligation to disclose and this withholding establishes the requisite element of causation in fact. (*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153, and 154 (1972)).

There can be no doubt that this plaintiff has pleaded the requisite scienter element under Count 6. In Paragraphs 47, 50, and 51 there are allegations of actual knowledge as well as the basis for implied knowledge. In any event the allegation that Shearson "knew or should have known" these facts is sufficient for pleading purposes.

> The charge that defendants "knew or should have known" adequately alleges actual knowledge of the falsity of the statements, and alternatively, negligence or lack of diligence in failing to ascertain the true facts. If some form of scienter test is to be applied . . . we think the alternative allegation of actual knowledge of falsity is amply sufficient as a matter of pleading. And this would seem to be so whether the scienter test ultimately applied be strict or liberal." (*Heit v. Weitzen*, 402 F.2d 909, 914, (2d Cir. 1968), cert. den. 395 U.S. 903 (1969)).

Further discussion of "scienter" is to be found under the discussion of County 10 hereinafter.

Thus under Count 6 plaintiff has alleged affirmative acts and material omissions each of which formed part of a process to conceal other violations and siphon off plaintiff's equity (a scheme to defraud and a process which did defraud); that certain of the essential acts of this scheme were performed, and material nondisclosures made, by Shearson (materiality and causality); that these acts and omissions were performed by Shearson with full knowledge of the earlier violations of law and the whole scheme and its consequences (scienter); and that the plaintiff ". . . suffered an injury as a result of deceptive practices touching its [purchase or] sale of securities as an investor". (bracketed material added). *Superintendent of Insurance*, at 12-13.

Under Count 10 Plaintiff in Paragraph 73 realleges Paragraphs 46 through 53; 55 through 66 and 72. In Paragraphs 48 and 51 Plaintiff shows that Shearson knowingly

opened his account after failing to make or improperly making the calculation under NYSE Rule 431 in that it knowingly attributed market values in that computation for large numbers of securities therein with full knowledge that they would not support such values since they were thinly traded and speculative stock. See Point III *supra* and Paragraph 5 of Affidavit of Philip Hoblin in support of Shearson's Motion to Dismiss. Under Paragraph 56 Plaintiff further shows Shearson specifically represented that it would make such calculation correctly and daily. By its acceptance of the account it implied and reconfirmed that it had in fact done so. These representations both express and implied were false. Shearson is further alleged to have made these representations knowingly and with having concealed their falsity and the consequences thereof (¶ 52). Certainly this was the omission of a fact material to the average investor under the holding of *Affiliated Ute* quoted *supra*, at Page 31, and a scheme and artifice to defraud. In the court below Shearson took the position that it could not have omitted any statement under Rule 10b-5 since that subsection refers to omissions in connection with other representations and that no such other representations were alleged. With respect to the time when the account was opened, Plaintiff contends first as above that the actual acceptance was, in the context of the other representations, clearly a further representation that Shearson had properly made the computation and, second, that total nondisclosure or silence is in any event fully actionable under Rule 10b-5 as a violation of one or more of its subsections.

> The doctrine for which defendant . . . contends (10b-5 inapplicable to total nondisclosure) would tend to reinstate the common law requirement of affirmative misrepresentation. Such a tendency contravenes the purpose of Rule 10b-5 . . . which precludes not only the conveyance of half truths . . . but, as well, failure by the buyer to disclose the full truth so as to put the seller in an equal bargaining position. . . . *List v. Fashion Park Inc.*,

340 F.2d 457, 462 (2d Cir. 1965) cert. den. 282 U.S. 811 (1965).

Under Count 10 Plaintiff alleges a further violation of Rule 10b-5 arising out of this same computation but at a later date — the period February 1, 1970 through May 1970. Plaintiff alleges that Shearson continued to represent that it was properly making this calculation and seized control of the account allowing Plaintiff only some decision in which securities might be required to be sold and in fact the account was operated on this basis (¶ 57 and 58). Plaintiff for a period of three months was not given any account statements despite requests and was denied any information about his account except the representation of correctness as aforesaid upon which he relied (¶ 61, 57 and 59). Suddenly, after some months without any margin sales, Plaintiff was notified on April 27 that his account was at 4% maintenance, a full 21 points below the required 25% minimum limit and thereafter sold out (¶ 60). Plaintiff further alleges that the failure to advise him of the account's condition deprived him of material information (¶ 66). Finally, in Paragraph 74 Plaintiff alleges in summary the facts set forth immediately above, adding that Shearson "*knew or should have known*" of the improper maintenance and that it "*made the contrary representation knowingly or recklessly without knowing if* they were true . . ."

Plaintiff has alleged a scheme, course of conduct, or artifice to defraud consisting of misrepresentation of a fact which could reasonably be expected to affect the investment judgment of an average investor. See *Affiliated Ute Citizens* at 153 (quoted supra page 31).

The court below ignoring in all of the allegations realleged under Paragraph 73 and the statement in Paragraph 74, alleging recklessness, actual knowledge, or the basis for knowledge (knew or should have known), has held

> The complaint alleges (paragraph seventy-five) that Shearson's allowing the account to fall below minimum margin requirements and into a deficit position was in violation of Section 10 of the 1934 Act and of Rule 10b-5. There are no allegations of fact in the complaint "amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud . . .". *Shemtob* vs. *Shearson, Hammill and Co.* 448 F.2d. 442, 445 (2 cir.). Count 10 does not properly plead a cause of action for violation of Section 10(b) of the Exchange Act or of Rule 10b-5. (Decision of the District Court at page A-38 infra.)

The District Court's decision with respect to Count 10 can only be interpreted as holding that Shemtob is factually on all fours with the instant case and that plaintiff has failed to allege scienter in the instant complaint. The plaintiff vigorously disputes both of these contentions.

The Shemtob plaintiffs were not deprived of any knowledge concerning the margin status of their account. In fact, their own pleadings indicate they were fully informed and that they decided they wanted to ride the market all the way down. See *Shemtob* at 445, especially at Note 3 setting forth Paragraphs 17, 18 and 19 of the Shemtob complaint. As set forth above, plaintiff in the instant case has alleged that he was told his account was being properly maintained and that he did not receive margin calls. The instant plaintiff did not have the opportunity or the basis to make the decision the Shemtobs made.

In addition, we note that the Shemtobs' account consisted of only one stock and that account was therefore subject to a daily computation by the Shemtobs who could with no difficulty know their exact margin position. Schedule A to the Shemtob complaint verifies this. Considering the Shemtobs had in fact received a call, which was insufficiently met, they were on notice that during the period in question their account was not com-

plying with the 25% limitation. In the instant case plaintiff's account consisted of a great number of stocks and was incapable of margin analysis without a full-time bookkeeper or a computer. Further, based on the handling of the account and the representations of Shearson, plaintiff was not put on any notice of improper maintenance. Even if he were he was denied certain basic records during the crucial three-month period rendering him incapable of making the computation even with a computer.

Thus, the Shemtobs could not have been defrauded with respect to the maintenance computation and sell out where the instant plaintiff was. There were no misrepresentations concerning maintenance alleged in Shemtob while the instant plaintiff has done so. Thus, the Shemtob complaint becomes only a violation of the alleged oral modification which (a) waived the house margin and (b) gave the Shemtobs the opportunity to provide collateral for any call based on the 25% limit. That, as this Court appreciated, was in fact a contract question. *Shemtob* at 445. Plaintiff does not allege any such novation or modification as the basis of its claim.

The Court did, however, indicate that even *Shemtob* would have been actionable if there were

> ". . . allegations of facts amounting to scienter, intent to defraud, reckless disregard for the truth or knowing use of a device, scheme or artifice to defraud." (*Shemtob* at 445.)

In the instant case plaintiff has, as noted above, pleaded that the computation was from the beginning made knowingly in an improper fashion (See discussion supra at page 35) and that Shearson during the February-May period "knew or should have known of the improper maintenance and that it "made the contrary representations *knowingly or recklessly without knowing if they were true* (¶ 74). The allegations of "knew or should have known" have been held sufficient to allege scienter under *Heit v. Weitzen* (quoted above at page 32). Further the

allegation in Paragraph 74 that the representations were made *knowingly or recklessly without knowing if they were true* is almost the exact language of this Court's requirement in *Shemtob* at 445 (quoted supra page 35). On the occasion on this Court's en banc opinion in *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir., 1973) this Court held in reviewing a judgment after lengthy trial as follows

> In sum, we believe that proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5. (*Lanza* at 1306)

In footnote 98 the court gave guides for determining what constitutes willful or reckless disregard:

> 98. In determining what constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort. *Chris Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F. 2d 341, 363-364, 396-399 (2d Cir. 1973) (*Lanza* at 1306).

While *Lanza* presents an evidentiary rather than a pleading standard, plaintiff has pleaded facts which, if true, now meet the higher standard and show that Shearson (even if it did not act knowingly, as alleged) acted willfully and with a reckless disregard for the truth. In Points I, II and III of this brief we have pointed out a variety of allegations supporting violations of Regulation T, NYSE Rule 405 and NYSE 431 respectively. In so doing the brief has pointed out that each such Regulation and Rule imposed a duty on Shearson which was not complied with and that in each instance of failing to comply Shearson had acted knowingly or with a flagrant and willful or reckless disregard for the truth — in short there was demonstrated scienter for each of these violations. Even if held not to be in-

dividually actionable, this chain of systematic and flagrant violations considered as a whole surely demonstrates that Shearson's whole approach to plaintiff's account was one of willful, grossly negligent, and reckless disregard for its handling in that it failed or refused after notice to apprise itself of the facts when it could have done so (and arguably was required to do so) without any extraordinary effort. See *Lanza* at 1306 quoted supra page 37.

In summary plaintiff has alleged *actual knowledge* which it will only be able to amplify on and prove by access to defendant's records. No further detail of pleading is now possible in this regard. Plaintiff has also alleged plaintiff *should have known* and a *reckless disregard for the truth.* While ordinarily further detail should not be required for such a pleading, plaintiff has in fact pleaded a number of underlying facts which support and demonstrate the obligation, the opportunity, and the ability of Shearson to have informed itself. In not doing this Shearson demonstrated its willful disregard for the truth. Plaintiff has pleaded "scienter".

Plaintiff has pleaded under Count 6 the knowing use of a scheme or artifice to defraud and the concealment of certain material facts, all in violation of Rule 10b-5. Under Count 10 plaintiff has pleaded affirmative material misrepresentation and non-disclosure in violation of Rule 10b-5. Under both Counts 6 and 10 plaintiff has pleaded facts amounting to "scienter". The decision of the District Court dismissing the complaint for failing to state a cause of action under Rule 10b-5 should be reversed.

POINT V

The Trial Court Erred in Dismissing the Complaint.

The foregoing summary of facts and application of law show clearly that plaintiff has several compelling causes of action against Shearson by virtue of violations of the Federal Securities Laws. Although the complaint does not plead every detail of the complex situations into which plaintiff was lead, it clearly sets out in narrative each of the necessary facts. As the narrative proceeds, the succeeding violations and causes of actions are pleaded. In as short a pleading as is consistent with the complexity of the facts and law, plaintiff has set forth ". . . a short and plan statement of the claim. . ." which amply gives the defendant Shearson ". . . fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley v. Gibson*, 355 U.S. 41, 47. "[W]here a bona fide complaint is filed that charges every element necessary to recover, summary dismissal of a civil case for failure to set out evidential facts can seldom be justified." *Nagler v. Admiral Corporation, et al*, 248 F.2d 319, at 323 (2d Cir. 1957), quoting *United States v. Employing Plasterers Association, et al*, 347 U.S. 186, 189 (1954). Moreover, where, as in the instant case, the plaintiff's claim is based upon complex business records made and kept by the defendant and upon the commission of acts by the defendants the evidence of which is solely within the knowledge and possession of the defendant, the action should not be dismissed before plaintiff has had an opportunity to engage in discovery proceedings. cf. *Schoenbaum v. Firstbrook, et al*, 405 F.2d 215, 218 (2d Cir. 1968); cert. den. 395 U.S. 906 (1969).

As stated in *Conley*, ". . . the complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, *supra*, at 45-46. Accordingly, it is respectfully submitted that the court below erred in dismissing the complaint.

POINT VI

The Trial Court Erred in Refusing to Grant Plaintiff Leave to Amend the Complaint.

For the reasons outlined above, plaintiff respectfully submits that his complaint is sufficient to state a cause of action against the defendant Shearson and, therefore, that the trial court erred in dismissing it as against that defendant. Plaintiff further submits that the trial court further erred in denying plaintiff leave to amend the complaint. While the grant of leave to amend the complaint is within the discretion of the trial court [*Zenith Radio Corporation v. Hazeltine Research, Inc.*, 401 U.S.321, 330 (1971)], Rule 15(a) of the Federal Rules of Civil Procedure provides that such leave shall be freely given. And, the United States Supreme Court, in *Foman v. Davis*, 371 U.S. 178, 183 (1962) has stated:

> In the absence of any apartment or declared reason — such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of the allowance of the amendment, futility of amendment, etc., — the leave sought should, as the rules require, be 'freely given.'

It is submitted that none of the above set forth reasons for denying leave to amend the complaint are applicable to the plaintiff in the instant case. In this regard, it is noteworthy that Judge Burke, in denying plaintiff leave to amend the complaint, did not set forth any justifying reasons for the denial. As stated in *Foman*,

> ". . .outright refusal to grant the leave [amend the complaint] without any justifying reason appearing for the denial is not an exercise of discretion; it is merely abuse of that discretion and inconsistent with the spirit of the Federal Rules." *Foman v. Davis, supra* at 182.

Accordingly, if this Court should hold that the complaint does not set forth sufficient facts to state a cause of action against the defendant Shearson, plaintiff respectfully requests that he be granted leave to amend the complaint to set forth such facts.

CONCLUSION

The order of the District Court dismissing plaintiff's complaint against the defendant Shearson should be reversed. Alternatively, plaintiff should be given leave to amend the complaint.

Respectfully submitted,

WISER SHAW FREEMAN VAN GRAAFEILAND
HARTER & SECREST
Attorneys for Appellant
Office and Post Office Address
700 Midtown Tower
Rochester, New York 14604
Telephone: 716 232-6500

John F. Mahon, *of counsel*

CERTIFICATION OF SERVICE

I hereby certify that I, this day, caused two copies of the attached brief for the appellant to be served upon defendant Shearson Hammill & Co., Incorporated, defendant New York Stock Exchange and defendant Nusbaum by delivering copies thereof to the office of the counsel of each such defendant, and upon defendant Winslow, Cohu and Stetson, Incorporated, by causing copies thereof to be mailed to its counsel at his office address. The counsel and their addresses to which the said copies were delivered and mailed were as listed in the said brief.

July 22, 1974.

John Mahon

John F. Mahon
Counsel for Appellant